

Holding Companies (RBHCs) as a risk proxy for the Bell Operating Companies (BOCs).³¹ This produces a cost of equity estimate for the LECs that is biased downward.³² Kahal also incorrectly uses the RBHCs' capital structure in his analysis, rather than the BOCs'.³³ As a result, he understates the average amount of equity in the LECs' capital structure by a substantial 773 basis points.³⁴

Additionally, MCI's Kahal uses the "annual form" of the discounted cash flow (DCF) model even though the RBHCs and most other firms issue quarterly dividends.³⁵ He also does not account for equity flotation costs.³⁶ All of these mistakes significantly bias Kahal's results downward.

AT&T does not recommend a current cost of capital, but instead performs a historical analysis using an incorrect form of the DCF model to estimate a cost of equity.³⁷ As an initial matter, the fact that AT&T has only provided historical evidence, albeit using flawed methodology, on the LECs' cost of capital from 1991 to 1993 makes AT&T's

³¹ Id. at 10-11.

³² Id. at 11-12.

³³ Id. at 12-13.

³⁴ See id. at 13.

³⁵ Id. at 13-14.

³⁶ Id. at 14-15.

³⁷ Id. at 15-16.

analysis irrelevant to an assessment of the LECs' current cost of capital.³⁸ Moreover, because AT&T used essentially the same form of the DCF model as MCI, and also used the RBHCs' capital structure in its analysis, AT&T's historical estimates are flawed by generally the same errors as Mr. Kahal's analysis.³⁹

In sum, neither MCI nor AT&T present persuasive evidence that the LECs' cost of capital has declined over the past several years.

C. There Is No Basis for MCI's Allegation that LECs Manipulate Fourth Quarter Earnings.

MCI makes the unfounded claim that price cap LECs "overstate their fourth quarter expenses" in order "to manipulate the sharing rules."⁴⁰ As an example, MCI points to the booking in the fourth quarter of such expenses as early retirement programs which MCI contends is an attempt on the part of LECs "to achieve a targeted earnings level."⁴¹

³⁸ Id. at 16.

³⁹ Id. The specific errors made by AT&T include: (1) improper reliance on the RBHCs as a risk-surrogate for the LECs; (2) incorrect use of the annual form DCF model including erroneous application of the estimated growth rate; (3) no allowance for equity flotation costs; and (4) the presentation of only historical estimates of the cost of capital that reflect neither current market conditions nor current consensus growth expectations. Id. at 16-17.

⁴⁰ MCI Comments, p. 33.

⁴¹ Id. at 34.

MCI's arguments should be summarily rejected. First, an expense is an expense no matter when it is booked. More specifically, earnings are measured on a calendar year basis. It makes no difference to the sharing mechanism when the expense is booked.

Second, there are reasons, other than the "booking of large costs" claimed by MCI, as to why earnings are generally lower in the fourth quarter. For example, annual LEC mid-year tariff rate reductions result in lower end-of-year earnings as compared to third quarter results. Additionally, the timing of depreciation rate represcriptions, which are sometimes booked in the fourth quarter, could reduce earnings for that period.⁴²

More to the point, USTA categorically denies that price cap LECs manipulate their earnings in order to undermine the Commission's sharing rules. Interstate earnings are only a portion of the LECs' business. Management decisions regarding expenditures on, and implementation of, programs such as early retirement or force reductions affect not only interstate results, but also intrastate and total company results that are reported to shareholders.

⁴² For example, in The Prescription of Revised Percentages of Depreciation, Memorandum Opinion and Order, FCC 93-40, released January 15, 1993, the Commission prescribed depreciation rates retroactive to January 1, 1992. Unless a LEC had obtained an interim booking letter from the Commission, LECs would have booked in the fourth quarter the entire change in depreciation costs for 1992.

Further, this pattern of expenditures is common to both regulated and non-regulated firms and is consistent with both standard accounting and sound business practice. MCI itself shows the identical expense pattern. For example, MCI's annual and quarterly earnings reports for 1991, 1992 and 1993 reveal expense increases in the fourth quarter.

Additionally, LEC books and records are audited annually by independent external auditors and all booked expenses must meet Generally Accepted Accounting Principles (GAAP) standards. LECs must also comply with Security and Exchange Commission (SEC) rules and policies, and with the Commission's own accounting rules and policies. LECs cannot arbitrarily book expenses in order to manipulate their financial results.

Accordingly, there is absolutely no reason for the Commission to require, as MCI proposes,⁴³ that LECs declare on or before September 15 of each year all one-time accounting adjustments for the fourth quarter. Such a policy would be an unwarranted interference with management's discretion, and could compromise a LEC's ability to comply with GAAP and SEC regulations.⁴⁴

⁴³ MCI Comments, p. 34.

⁴⁴ Of course, this whole issue becomes moot if sharing is eliminated from the LEC price cap plan. Indeed, MCI's meritless argument is a good example of the resource-wasting issues that the Commission must contend with so long as LEC price caps remain tied to rate of return regulation.

III. THE COMMISSION MUST REJECT ARGUMENTS THAT WOULD ERECT INSURMOUNTABLE HURDLES TO MEANINGFUL COMPETITION IN ACCESS MARKETS.

A. Substitutable Access Services in a Defined Geographic Area Is the Relevant Market for Assessing Whether There Is Sufficient Competition To Grant LECs Pricing Flexibility.

A few parties take positions that would make it all but impossible for LECs to effectively respond to competitive entry into access markets, and which would deny consumers the benefits of full competition. MFS Communications Company, Inc. (MFS), for instance, argues that the "Commission should examine whether a LEC is subject to competition for all services in a given geographic area" ⁴⁵ MFS then proposes a long list of conditions that it claims must be satisfied before competition can exist. ⁴⁶ Teleport Communications Group, Inc. (Teleport) "believes that the relevant market for assessing competition should be the total regulated market currently served by LECs, which would include access services, intraLATA toll, and associated (tied) services (such as directory assistance, directory publishing)." ⁴⁷ It claims, not

⁴⁵ MFS Comments, p. 44 (emphasis in original).

⁴⁶ Id. at 46-50. See AT&T Comments, pp. 16-18. (Lists "nine specific steps that should be taken to create the essential conditions under which exchange and exchange access competition can best develop"); MCI Comments, pp. 73-76. (Specifies conditions for "establishing a framework that will encourage the development of interstate access competition.")

⁴⁷ Teleport Comments, pp. 22-23.

surprisingly, that LEC competitors have less than 1% of this all-encompassing, geographically-boundless market.⁴⁸

These arguments must be rejected. A relevant market assessment cannot be based on all LEC services offered in all service areas.⁴⁹ Relevant markets are geographically discrete,⁵⁰ and consist of particular access services and their close substitutes.⁵¹ As Schmalensee and Taylor note,

⁴⁸ Id. at 23. Other parties make similar claims with regard to the LECs' share of total access markets. See, e.g., Ad Hoc Comments, Attachment A, p. 100 ("99% of America's long distance traffic" still must pass through the LECs); AT&T Comments, p. 9 ("AT&T estimates that CAPs account for less than one percent of nationwide access revenues") These claims are often based on distorted figures which do not accurately reflect the amount of business already lost by LECs to competitive access providers. See Testimony of Roy Neel, President of USTA, before the Senate Committee on Commerce, Science and Transportation, May 18, 1994, pp. 2-3. For instance, most market share figures generally omit access provided by the IXCs themselves and private networks. See Harris Reply, p. 13.

⁴⁹ As Schmalensee and Taylor note (Reply, p. 2): "Market power is a meaningful concept only in the context of an economic market, and such markets have both service and geographic components." This is not to say, of course, that a LEC could not face competition for one or more services across its entire serving area.

⁵⁰ The Commission recognized the local nature of telecommunications service markets in implementing the "effective competition" standard for relieving cable operators of rate regulation. See Implementation of Sections of the Cable Television Consumer Protection Action of 1992, Rate Regulation, Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 92-266, FCC 93-177, released May 3, 1993, ¶ 49. See Harris Reply, p. 6.

⁵¹ See Schmalensee and Taylor Reply, p. 6. ("For assessing market power for interstate carrier access services, all that matters is the substitutes available to
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the claim that the relevant market for assessing the degree of competition should be the total market served by the LECs, "is economic nonsense which makes a mockery of market definition."⁵²

From a geographic standpoint, a "market" is the area in which customers have relatively consistent access to alternative supply.⁵³ It is simply misleading to "lump in" LEC demand from areas where no alternative exists with demand from highly competitive areas in order to "dilute" the measure of CAP presence in these competitive geographic markets.⁵⁴

Moreover, it makes no sense to compare total, nationwide LEC revenues to the total, nationwide revenues of competitive access providers (CAPs) when those providers have made clear their intent to focus on those services and

⁵¹(...continued)
customers for the LEC's interstate carrier access services.")

⁵² Schmalensee and Taylor Reply, p. 5.

⁵³ See id. at 10. ("[I]f alternative providers have capacity in place that can be brought on line at low additional cost so that the customer has a real choice of suppliers, the incumbent firm cannot exercise market power.")

⁵⁴ Several non-LEC parties recognize this already. Wiltel, Inc. (Wiltel) states that "competition will develop at different paces for different services in different geographic locations." Wiltel Comments, p. 34. See MCI Comments, p. 72. ("The Commission should grant regulatory relief only in those geographical areas where effective competition exists.")

geographic areas for which there is a concentration of traffic that makes competitive entry profitable.⁵⁵ As a result, directory publishing in Wyoming, and even residential local service in Boston, has absolutely no relevance to competition in other areas, such as the market for high-capacity services in downtown Los Angeles where competitive service providers have already captured 30% of the market.⁵⁶

Further, MFS, Teleport and other parties fail to acknowledge the highly concentrated nature of LEC access markets - both from a geographic and service standpoint - which makes large percentages of LEC revenues very vulnerable to competitive incursions and which further support differentiation of geographically discrete access markets from a nationwide local services market.⁵⁷ As

⁵⁵ Professor Harris notes that a "focus strategy," such as that being pursued by competitive entrants into LEC access markets, "is particularly effective when there is a high degree of market segmentation and when revenues are highly concentrated into relatively small portions of the product lines or geographic space. Both conditions apply to access services, in spades." Harris Reply, p. 14 (emphasis deleted).

⁵⁶ See USTA Comments, pp. 35-36. See Schmalensee and Taylor Reply, p. 5. ("Possible market power in directory publishing has no connection with the LECs' ability to maintain interstate carrier access prices above competitive levels.")

⁵⁷ These parties also fail to recognize that significant LEC competition comes from the ability of IXCs to supply access service themselves rather than purchase it from a third party. See Schmalensee and Taylor Reply, p. 11.

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discussed by Professor Harris in his report on "Economic Benefits of LEC Price Cap Reforms," submitted as Attachment 2 to USTA's comments, "[i]n telecommunications services, the distribution of revenues is highly concentrated: a small percentage of customers, lines and geographic areas account for a very large share of revenues in most service categories" ⁵⁸ Thus, almost 71% of Bell Atlantic's special access revenue is derived from 15% of its wire centers. ⁵⁹ Similarly, 92% of GTE's special access channel terminations are located in just 13% of GTE's central offices, and just 6/10 of 1% of GTE's end user customers account for all of GTE's special access channel terminations. ⁶⁰ With geographic and customer concentrations

⁵⁷(...continued)

There is evidence that such self-supply is "substantial." Harris Reply, pp. 13-14. Indeed, some observers believe that IXCs are the most formidable competitors to the LECs. See Joseph S. Kraemer, "The Future of Local Competition: The Wars of All Against All," *Business Communications Review*, March 1993, pp. 35-40. ("It should never be forgotten that the primary source of competition for the LECs is the interexchange carrier industry.")

⁵⁸ See USTA Comments, Attachment 2, Appendix B, p. B-2. This is not to say that CAPs have only a limited presence in access markets. Harris notes that "CAPs are currently operating networks in 222 cities and have plans to enter 41 more." Harris Reply, p. 15 (emphasis in original).

⁵⁹ USTA Comments, Attachment 2, Appendix B, p. B-3.

⁶⁰ GTE Comments, p. 28. With such LEC service concentrations, it is not surprising that the competitive initiatives of other service providers are also highly concentrated. For example, although NYNEX's service area accounts for only 10% of nationwide access lines, it represents 1/2 of the total revenues of the two largest CAPs. See NYNEX Comments, p. 13.

such as these, any competitive analysis must be based on a market segmentation such as proposed by USTA.⁶¹

Both MFS and Teleport argue, however, that it is necessary to analyze the total local market served by LECs because LECs utilize common facilities to provide many of their services.⁶² According to these parties, this permits LECs to "cross-subsidize" the prices of services facing more competition by "shifting" shared and common costs to services facing less competition.⁶³

Contrary to MFS's and Teleport's specious arguments, it is not possible for LECs to engage in cost-shifting which would result in higher rates for less competitive services. For one thing, USTA's price cap proposal isolates competitive access services from other access services and, thus, removes both the incentive and ability to cross-subsidize.⁶⁴ Even apart from USTA's proposal, there is no way for a LEC to cross-subsidize competitive interstate

⁶¹ See USTA Comments, pp. 58-59, 67-69. USTA's "market area" concept views wire centers as the smallest relevant geographic market (but permits aggregations of wire centers) and establishes service classifications based on the composition of the price cap baskets.

⁶² See MFS Comments, pp. 38-39; Teleport Comments, p. 23.

⁶³ See MFS Comments, p. 39; Teleport Comments, p. 23.

⁶⁴ See USTA Comments, pp. 64-66, 70.

access service with intrastate local exchange service.⁶⁵

First, LECs are subject to the jurisdictional separation rules.⁶⁶ More importantly, a LEC's price actions regarding interstate services has no impact on, or connection to, its ability to raise rates for basic local exchange service.⁶⁷ In short, it is not true that a "LEC can shift the recovery of shared and common costs to other services or geographic niches" ⁶⁸

Finally, the competitive conditions proposed by MFS, AT&T and MCI should be viewed by the Commission for what they are intended to be - devices to delay, or prevent, full competition by LECs in access markets. These criteria should not be allowed to serve as road blocks to LEC

⁶⁵ Historical experience suggests just the opposite. Access services have contributed to the cost recovery for local services. See "Federal Perspectives on Access Change Reform," FCC Access Reform Task Force, April 30, 1993, pp. 53-54.

⁶⁶ See 47 CFR Part 36.

⁶⁷ If LEC interstate access service rate decreases did affect local rates, one would have expected local rates to have increased significantly across the nation over the past decade in response to the precipitous drop in access rates during this period. Yet, many states have not had a local service rate increase in years. Many states also have rate freezes or incentive regulation plans in effect that make it impossible to increase local rates for any reason, let alone to offset interstate rate decreases.

⁶⁸ MFS Comments, p. 39.

competitive response.⁶⁹ For example, MFS proposes that the Commission allow pricing flexibility only after 11 conditions, most requiring state legislative and/or regulatory action, are satisfied.⁷⁰ Under MFS's proposal, a LEC could lose, for instance, 80% of its high-capacity access services to competition, but could still not respond to that competition if the state regulator did not "formally certify" that all of MFS's conditions were met.⁷¹

⁶⁹ Professor Harris concludes that the "basic premise of 'precondition' - that all barriers to competition be removed and all local exchange markets be fully competitive before adopting transitional regulatory mechanisms - is fundamentally misguided." Harris Reply, p. 23. This is so because the transition is going on now and the "Commission needs policy mechanisms that adapt to changing competitive conditions as they occur," not after the transition to competition is complete. *Id.* (emphasis deleted).

⁷⁰ MFS Comments, pp. 46-49. AT&T would require satisfaction of its nine criteria before the Commission can even consider what is the appropriate measure of competition which must have already occurred. AT&T Comments, p. 18. In short, AT&T's criteria are a precondition to a precondition to LEC pricing flexibility. Like MFS's, several of AT&T's preconditions are not even within the Commission's jurisdiction. *See* Harris Reply, p. 23. Other preconditions mentioned by AT&T are not relevant to competition in access services. *Id.*

⁷¹ *See* MFS Comments, p. 46. If these conditions were met, MFS would likely propose a whole new set of conditions which, it would argue, would also have to be met before LECs could compete.

B. The Only Constant Is Change.

Several parties are quick to dismiss the idea that LECs will face competition any time soon.⁷² For the reasons set forth in USTA's Comments (pp. 33-40, Attachment 2, Appendix B), USTA submits that access competition already exists and will grow at an accelerated rate in the future.⁷³ This growth will come from (1) CAPs which "have announced plans to build networks in many new cities;"⁷⁴ (2) cable companies whose networks "are already used for the backhaul of voice and data transmissions for cellular providers and CAPs," and which "are beginning to provide telephony services directly over their cable networks;"⁷⁵ and (3) IXC's which "also plan to expand their offerings of local services."⁷⁶

⁷² See, e.g., AT&T Comments, p. 19 ("[N]o possibility of significant local competition in the next several years."); Opening Comments of the Association for Local Telecommunications Services (ALTS), p. 3 (An "increased potential for competition," but nothing "to justify lessening regulatory strictures for at least five to ten years, at best."); MFS Comments, p. 38 ("The supposed 'competitive threat' facing the LECs is imaginary today . . ."); MCI Comments, p. 64 ("LECs remain defacto monopolists" and will "continue to dominate the markets they serve.")

⁷³ While it is not relevant to competition in access markets, USTA shows below that there is strong evidence of increasing competition in local exchange markets.

⁷⁴ Harris Reply, p. 21. Professor Harris points to the "extraordinary market valuations" of CAPs as strong evidence of their "rapid growth prospects." Id.

⁷⁵ Id. at 16 (emphasis deleted).

⁷⁶ Id. IXC and end user self supply will also grow. Id. at 18-19. Further, wireless services will provide
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One only has to look at events that have transpired in the few weeks since comments in this proceeding were filed to realize that, if anything, USTA understated the pace of change which is transforming the telecommunications industry and opening markets to competition. For example -

- Rochester Telephone announced an agreement with the New York Public Service Commission staff that, when approved, would open the local exchange market in Rochester, NY, to full competition effective January 1, 1995.⁷⁷
- Time Warner Communications quickly announced its intention to use its cable-television facilities in Rochester to provide telephone service to residential and business customers.⁷⁸
- MFS announced its intention to compete in the Rochester local service market.⁷⁹
- Southwestern Bell filed with the Maryland Public Service Commission for permission to provide "competitive telephone service to every household in Montgomery County," Maryland, a jurisdiction in which Southwestern Bell owns the franchised cable operator, and Bell Atlantic is the local telephone company.⁸⁰

⁷⁶(...continued)
substantial competition to LECs, as will electric companies and other LECs. See USTA Comments, pp. 36-38, and references cited therein.

⁷⁷ *Communications Daily*, "Rochester Tel Close to Implementing Landmark Plan," May 18, 1994, p. 1.

⁷⁸ *New York Times*, "A Telephone Role By Time Warner," May 18, 1994, § A, p. 1.

⁷⁹ See *Local Competition Report*, "MFS Seeks Co-Carrier Deal with Rochester Tel, Eyes Other States," May 30, 1994, p. 8.

⁸⁰ *Communications Daily*, "Southwestern Bell Seeks MD PSC Approval for Cable Telephone," May 23, 1994, p. 1.

- Senators Breaux and Packwood introduced legislation that would set deadlines, as soon as next year, for removing all regulatory obstacles for full interstate and intrastate competition in telecommunications markets.⁸¹
- At its annual shareholders' meeting, MCI's Chairman and Chief Executive Officer stated that MCI's recent investment in Nextel Communications, Inc., would provide MCI with a "big opportunity to go after the local exchange market by providing cordless, wireless telephone service."⁸²
- Shortly before comments were filed, the Maryland Public Service Commission granted MFS "co-carrier" status and authority to provide interexchange and local exchange services.⁸³

Other examples can be cited.⁸⁴ The point is that,

⁸¹ See *Telecommunications Reports*, "Breaux Bill Would Allow RHC Entry After One Year, Not Require Separate Affiliates for Video Programming," May 16, 1994, p. 1.

⁸² *Telecommunications Reports*, "MCI Cites Nextel's Role in Local Competition Plans," May 30, 1994, p. 16. MCI's comments are just one example of public statements made, and actions taken, by parties that are inconsistent with the same parties' positions on competition in this proceeding. See Harris Reply, pp. 21-22.

⁸³ *Telecommunications Reports*, "Maryland Opens Local Exchange to Competition In Order Granting MFS 'Co-Carrier' Status," May 2, 1994, p. 1.

⁸⁴ LEC competitors are likely to argue that the Court's decision in *Bell Atlantic Telephone Companies v. F.C.C.*, Nos. 92-1620, 93-1028 and 93-1053, slip op. (D.C. Cir. June 10, 1994), which vacated the Commission's decision requiring physical collocation, will hinder their ability to enter LEC markets. USTA notes, however, that on the first full day of trading after the Court's decision, MFS stock increased by almost 9%. The increase was attributed to a statement by MFS's Chief Executive that the Court's decision "would have no material effect" on MFS' development plans. See *Wall St. J.*, "Abreast of the Market," June 14, 1994, at C-2. MFS's President and Chief Operating Officer also downplayed the impact of the decision on competition, stating that "the important thing is to realize that [the decision] affects who owns and maintains the equipment in the central office,"
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regardless of one's views on the state of competition today, there can be no denying that there will be not only access competition, but also local exchange competition, in many markets in the very near future.⁸⁵ As discussed below, this calls for an adaptive approach to regulation that will reflect the nature and extent of competition as it evolves in access markets.

C. There Is No Excuse for Not Adopting Procedures That Will Permit an Orderly Transition to a More Competitive Industry Environment.

A few parties would like the Commission to ignore the changes that are taking place in local and access markets and put off for another day any consideration of how to transition regulation as markets become more competitive. AT&T, for one, argues that it is "unnecessary to address this issue specifically at this juncture"⁸⁶ Similarly, Time Warner states "that there is no imminent need for a 'transition' plan for LEC price caps."⁸⁷

⁸⁴(...continued)
not our ability to interconnect." *Telecommunications Reports*, "Appeals Court Overturns Expanded Interconnection Order to FCC," June 13, 1994, p. 42.

⁸⁵ See Harris Reply, pp. 15-17.

⁸⁶ AT&T Comments, p. 19.

⁸⁷ Time Warner Comments, p. 6; see, e.g., Comments of Sprint Corporation (Sprint), p. 26 ("[I]t is entirely premature to consider adoption in this rulemaking, of a specific transition plan or hard-and-fast criteria for determining when effective competition exists."); OCCO
(continued...)

These arguments should be rejected. As Professor Harris states, "the need for regulatory reform is based not only on the state of the market, but on the rate of change in the market."⁸⁸ As demonstrated immediately above, the current rate of change in local telecommunications markets is nothing short of astounding.⁸⁹ Summarizing, Professor Harris notes that the "direction of change is toward more competition; and the rate of change is fast."⁹⁰

In view of these changes, the failure to adopt procedures, such as proposed by USTA,⁹¹ for an orderly regulatory transition to competition would be a grave mistake. As discussed below, no costs or risks will be incurred in affirmatively addressing the transition issue at this time. Indeed, substantial benefits would result from

⁸⁷(...continued)
Comments, p. 13 ("[A]t present there is no real need to consider these issues")

⁸⁸ Harris Reply, p. 3. (emphasis in original).

⁸⁹ Harris notes that the "rate of entry and expansion by CAPs is . . . virtually unmatched in any other mature industry." *Id.* at 12.

⁹⁰ *Id.* at 3. Contrary to Time Warner's position here, its president believes that there is "significant opportunity for very quick movement" in regulatory changes that will permit cable companies to offer local telephone service to residences and small businesses. *See Warren's Cable Regulation Monitor*, "Cable Sees Regulatory, Not Technical, Barriers to New Service," May 9, 1994, p. 3.

⁹¹ *See* USTA Comments, pp. 57-78.

such a policy. There are major risks, however, in putting off consideration until a later date.

As an initial matter, USTA stresses that the Commission does not have to decide at this time whether any particular access market, or segment of the exchange carrier industry, is competitive. The Commission need only provide for a mechanism that will permit the LEC price cap plan to "adapt" to the myriad changes that are taking place in the telephone industry;⁹² changes which promise to significantly alter the competitive landscape.⁹³ There is absolutely no downside in putting a transitional mechanism in place now. It will not pre-judge the level of competition in any market.⁹⁴ As Professor Harris notes, "USTA's proposed market classification system does not change anything until a LEC can demonstrate that competitive conditions justify a reclassification under the system."⁹⁵ If sufficient competition in a particular market does not develop, access services would simply remain subject to the highest level of

⁹² These changes, including technology, customer demand and new market entrants, are discussed at length in USTA's Comments at pp. 25-44, and Attachment 2, Appendix B.

⁹³ Professor Harris notes that "[r]apid changes and growing differences in telecommunications markets and technology require policies that are adaptive." USTA Comments, Attachment 2, p. 17.

⁹⁴ See Harris Reply, p. 4 (emphasis deleted). (The "transition mechanism is designed to be implemented only when actual market conditions change.")

⁹⁵ Id.

regulatory scrutiny, and the lowest level of pricing flexibility, under USTA's price cap plan.⁹⁶

Professor Harris explains that "[t]here are substantial benefits to acting in anticipation that competition will develop even further than it already has. By adopting a policy framework that will facilitate and accommodate changing technological, competitive and market conditions, the Commission will be sending valuable signals to investors, competitors and customers."⁹⁷ Such a transitional regulatory framework "will reduce the degree of uncertainty and risk concerning the effects of increased future competition, giving competitors, potential entrants and customers the information they need to make long-term business decisions, such as long-lived capital investments and long-term supply contracts."⁹⁸

In contrast, if a transition mechanism is not adopted now, the risk of not achieving an orderly transition to competition, and the potential for generating economic loss to society, are substantial. For example, if transition procedures are not adopted now, and significant market entry occurs in individual access markets, LEC competitive response to that market entry would be thwarted until the

⁹⁶ See USTA Comments, pp. 69-70.

⁹⁷ Harris Reply, p. 4 (emphasis deleted).

⁹⁸ Id. at 5.

Commission could complete another proceeding.⁹⁹ This has two main consequences. First, the expected consumer benefits of full competition - in particular, lower prices - will not materialize unless the LECs are provided an opportunity to respond in a fair and measured way to competitive market entry. Second, the absence of a transition mechanism will send distorted economic signals to new market entrants, causing "dynamic inefficiencies by inducing uneconomic entry and investment" ¹⁰⁰ This will result in "an important, though hidden, waste of social resources in the construction of the modern information infrastructure."¹⁰¹

Some parties suggest, however, that price cap LECs already have sufficient pricing flexibility. MCI, for example, "believes the current composition of [price cap] baskets gives the LECs adequate pricing flexibility to

⁹⁹ Even under the best of circumstances, regulatory lag could significantly delay Commission action. When the Commission considers complex and contentious issues such as those presented here, the delay is likely to be substantial.

¹⁰⁰ Harris Reply, p. 4; see Mark Shankerman, "Regulatory Reform for Local Exchange Carriers: Competition through Regulatory Symmetry," p. 12, appended as Attachment A to GTE's Comments in this proceeding. (The lack of a transition mechanism "will induce capital investment decisions based on factors unrelated to relative efficiency levels.")

¹⁰¹ Shankerman at 12.

respond to any emergence of competition for those services that potential competitors are beginning to offer."¹⁰²

MCI and the other parties are wrong. While the price cap baskets and bands, and zone density pricing, have provided LECs with a minimum level of pricing flexibility,¹⁰³ this flexibility is entirely inadequate to allow for a fair, but meaningful, LEC response as competition continues to develop in access markets. For example, because the lower pricing bounds for service categories do not match the lower pricing bounds for density zones (*i.e.*, the DS3 sub-band can be decreased by an aggregate of only 5% per year compared to a 10% decrease for density zones), LECs have, as a practical matter, far less pricing flexibility as a result of the pricing zones than might be apparent at first glance. Moreover, unlike their competitors, LECs cannot respond to specific customer needs with individually tailored solutions. Further, as detailed in USTA's Comments (pp. 72-75), the tariff filing and

¹⁰² MCI Comments, p. 16; see, e.g., AT&T Comments, pp. 39-40; Ad Hoc, p. 17 ("Generally, price cap LECs already possess sufficient pricing flexibility."); Teleport Comments, p. 9.

¹⁰³ See Expanded Interconnection with Local Telephone Company Facilities, Report and Order, CC Docket No. 91-141, 7 FCC Rcd. 7369, 7454-55 (1992) (Density zone pricing applied to special access); Transport Phase I, Second Report and Order and Third Notice of Proposed Rulemaking, FCC 93-379, released September 2, 1993 (Density zone pricing applied to switched access).

approval process prevents the timely introduction of new and restructured services.¹⁰⁴

It is important to emphasize that under USTA's proposal, LECs would not be granted a significant increase in pricing flexibility at this time. USTA's proposal would restructure the price cap plan's baskets and bands to allow for the grouping of rates along functional lines,¹⁰⁵ and would provide only minimal additional pricing flexibility over that which currently exists. The proposal will, however, establish a framework to facilitate increased pricing flexibility where warranted by competitive conditions.¹⁰⁶ Again, there is no risk in undertaking these changes. All services in all market areas would initially fall into the IMA classification which permits very little pricing flexibility. Only if LECs make satisfactory showings that competition exists, would LECs receive additional pricing flexibility for competitive services in defined geographic areas.¹⁰⁷ If competition does not

¹⁰⁴ The Commission must refrain from creating multiple new service categories and pricing subindices each time a LEC introduces a new service or restructures an existing service.

¹⁰⁵ See USTA Comments, p. 67.

¹⁰⁶ See id.; Harris Reply, p. 4.

¹⁰⁷ USTA believes that some market areas would currently meet any reasonable test of competitiveness.

develop in a particular area, the additional pricing flexibility will never materialize.¹⁰⁸

In sum, an objective cost/benefit (cost avoidance) analysis makes the Commission's choice clear. It should proceed immediately to adopt a transition plan, such as proposed by USTA, that will provide an objective and orderly transition to a more competitive industry environment.

D. Addressability Remains the Most Appropriate Measure of Competition in Access Markets.

Several parties propose criteria for determining whether competition is present in an access market. As discussed below, each of these proposals suffers from one or more shortcomings which preclude their adoption by the Commission.

¹⁰⁸ This "adaptive" approach is similar to the approach the Commission took in implementing the provisions of the Cable Television Consumer Protection and Competition Act, Pub. L. No. 102-385, 106 Stat. 1460 (1992) (Cable Act of 1992) where cable operators were to be freed of rate regulation as soon as they presented evidence sufficient to demonstrate the presence of "effective competition". See Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 92-266, supra at ¶ 42. Professor Harris notes that several aspects of the Commission's approach to assessing cable competition are directly applicable to LEC price cap reform. See Harris Reply, p. 5. Among other things, Harris observes that in determining the presence of competition in cable markets, the Commission "takes an appropriately broad view" of the competitive alternatives, does not require "equality" of services before there can be competition, and provides a way for cable operators to obtain information on the penetration and reach of their competitors' operations. See id. at 6-7.

Surprisingly, AT&T advocates a market share approach.¹⁰⁹ As USTA's Comments noted (p. 60, n. 156), AT&T has consistently maintained that market share should not be used to measure market power.¹¹⁰ More importantly, market share is simply the wrong measure of market power.¹¹¹ It does not reflect the availability (or capacity) of alternative service providers which is an important determinant of market power because it is the "availability of alternatives that gives customers the ability to substitute away from the LEC's services if it prices them above the competitive level."¹¹²

Additionally, as formulated by the non-LEC parties in this proceeding, a market share measure excludes access supplied by IXCs and end users which are important components of the access market.¹¹³ Finally, market share

¹⁰⁹ See AT&T Comments, p. 18. MFS takes a similar position. MFS Comments, p. 45.

¹¹⁰ See Schmalensee and Taylor Reply, p. 9.

¹¹¹ See id. at 10.

¹¹² Id. at 14.

¹¹³ See Harris Reply, p. 13. Market share data is also biased because it reflects services that LECs are obligated to provide by regulation. Sales of service provided pursuant to regulatory obligations at less than cost "do not provide any evidence whatsoever of the LEC's 'market power'; they merely mean that the LEC is fulfilling its obligation." Id.

is a backward-looking indicator that sends distorted and non-economic price signals to new market entrants.¹¹⁴

Teleport proposes that the Horizontal Merger Guidelines, used by the U.S. Department of Justice (DOJ) and the Federal Trade Commission to evaluate the legality of potential mergers, should be used by the Commission to determine whether "a group of LEC-provided interstate services should be allowed reduced or streamlined regulation."¹¹⁵ The problem with Teleport's approach is that it assumes that market share based on revenues is the appropriate measure in applying the Merger Guidelines.¹¹⁶ As Schmalensee and Taylor noted in their report appended to USTA's comments, however, that assumption is true only for markets where firms are distinguished primarily by differentiation of their products.¹¹⁷ For homogeneous products (like carrier access services), physical capacity, or the fraction of the market that can be served by a competitor, is the most appropriate measure.¹¹⁸

Further, regardless of how you measure it, the determinant of market concentration under the Merger

¹¹⁴ See USTA Comments, pp. 60-61.

¹¹⁵ Teleport Comments, pp. 17-18.

¹¹⁶ Id.

¹¹⁷ See USTA Comments, Attachment 4, p. 10.

¹¹⁸ See id.